Economic Update

Committee on the Budget ▪ Majority Caucus
U.S. House of Representatives
Jim Nussle, *Chairman*

309 Cannon House Office Building
Washington, DC 20515 ▪ (202) 226-7270
James T. Bates, *Chief of Staff* ▪ www.budget.house.gov

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Economy Makes a 'Soft Landing'

Overview

Evidence from both the third and fourth quarters indicates the economy has achieved a widely hoped-for "soft landing": sustaining modest growth at comfortable levels of inflation. Meanwhile, declines in the housing and automobile sectors have not become significant drags on the general economy.

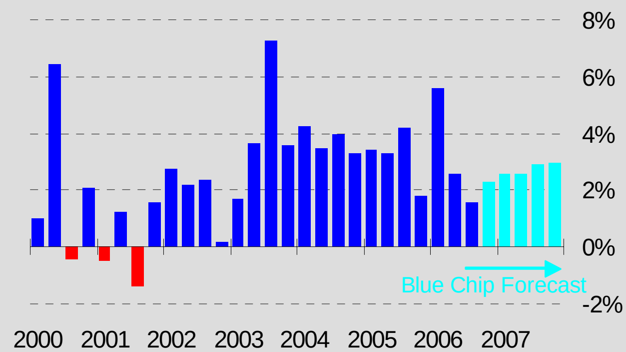
As had been expected, the level of economic growth in the third quarter moderated considerably from the rate recorded in the first half of the year; although it is forecast to rise to "trend levels" – at or near 3 percent – over the next four quarters. Most of the third-quarter moderation resulted from a drop in housing starts, the large overhang of unsold new homes, and a slowdown in automobile production.

The plunge in energy prices – especially gasoline – eased price pressures, although core inflation over the past year still exceeds the Federal Reserve's comfort zone. Sustaining the currently low levels of inflation throughout the Fall would greatly improve the economic outlook.

Tight labor markets and strong growth in wages and benefits have been favorable to workers. In addition to steady job creation, the unemployment rate now stands at a 5-year low.

Economic Growth Since 2000 — Fig. 1

(Real annualized GDP growth rate in each quarter)



Sources: Bureau of Economic Analysis

Highlights

- The economy grew at a 1.6-percent real (annualized and adjusted for inflation) rate in the third quarter of 2006, and Blue Chip forecasters expect 3.3 percent growth for all of 2006 and 2.5 percent growth in 2007 (see Figure 1). The slowdown in housing starts (18 percent below last year's level), and unsold home inventories at historical highs subtracted nearly a percentage point from third-quarter growth and will likely continue to detract from potential growth before reverting to trend by the middle of next year.
- Prices of crude oil and gasoline fell from historical highs to their lowest levels this year. Energy costs have fallen because of increased stockpiles and decreased political tensions worldwide. As prices hover near their lows, inflation pressures brought on by the energy shocks have abated, to the point where price *deflation* was measured at the wholesale and retail level this month. The Blue Chip forecast is for zero inflation over the rest of the year (see Figure 2).
- The 92,000 new jobs created in October is about half the average rate of job creation for the entire expansion that began 38 months ago. But this lower job-growth rate reflects how tight labor markets have become. Unemployment in October declined to 4.4 percent, well below the 5-percent rate widely considered to be full-employment.

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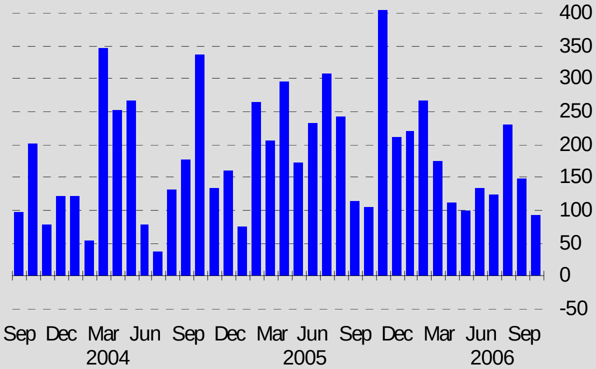
6.9 Million Jobs in Past 38 Months

(Change in employment, in thousands)

Fig. 2



Source: Bureau of Labor Statistics

Blue Chip Economic Outlook, September 2006								
	2006				2007			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
	Actual			*Projected*				
Real GDP Growth	5.6	2.9	1.6	1.8	2.6	2.6	2.9	3.0
Unemployment Rate	4.7	4.6	4.7	4.6	4.9	4.9	4.9	5.0
CPI Inflation	2.2	4.9	3.0	0.0	2.8	2.6	2.4	2.3
3-month Treas. Bill	4.4	4.7	4.9	5.0	4.9	4.9	4.8	4.7
10-year Treas. Note	4.6	5.1	4.9	4.8	4.8	4.9	4.9	5.0

Housing Market

The Census Bureau reports that vacant houses for sale in the third quarter equaled 2.5 percent of the total stock of housing, a full percentage point higher than the average vacancy rate since 1960. Housing starts are at a 6-year low and 27 percent below year-ago levels. New and existing home sales volumes and prices are both below year-ago levels. Tentative signs of recovery include declining 30-year interest rates, rising levels of mortgage applications, and an improvement in homebuilder confidence.

The decline in housing construction was estimated to detract a full percentage point from third-quarter growth. Housing values are also known to affect consumer spending decisions at the margin, and because spending is about 70 percent of the size of the economy, the *wealth effect* from dropping housing values on perceived homeowner wealth, and therefore spending, seems to be small. Rather, measures of consumer confidence are at or near their yearly highs, largely due to the relief in energy prices, and as a result consumer spending and retail sales (excluding spending on gasoline) have remained healthy.

Inflation on Edge of ‘Comfort Zone’

October data showed headline inflation was down 0.5 percent for the second straight month, led by double-digit monthly drops in the price of motor fuel. The core rate, excluding food and energy costs, was up only 0.1 percent, equivalent to a 1.2 percent annual rate of inflation, clearly the Fed’s wish for the future. The past is not so kind, however, as core prices have risen by 2.7 percent over the year, the highest rate since 2001.

The Federal Open Market Committee [FOMC] is expected to keep interest rates at 5.25 percent at its next meeting in December, the level at which the FOMC has held rates since June. Markets widely expect rates to remain steady through the spring, with about equal likelihood that they could rise, drop, or remain the same at the FOMC’s March meeting. Monetary policy appears to be essentially neutral at present.

Labor Markets Continue to Grow

Since September 2003, more than 6.8 million new jobs have been created, including 2.2 million in the past 12 months. Revisions in the employment numbers for July, August, and September – and a further adjustment showing 800,000 more people working in March 2005 (used as a benchmark for subsequent gains and losses) – all combine to show more firmness in employment. Incomes improved as well: total compensation of employees was estimated to have increased by 4.1 percent (annualized) in the third quarter.

Upcoming Indicators

Inflation - The Consumer Price Index for November is scheduled to be released on *December 15.*

GDP - Preliminary GDP (i.e. the first revision) for the 3rd quarter is scheduled for release on *November 29.*

Employment - The November employment situation will be released on *December 8.*

Federal Reserve - The Fed’s next monetary policy meeting is scheduled for *December 12.*

Prepared by . . . . Jeffrey W. Hopkins
Chief Economist